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In the Supreme Court of the United States

OCTOBER TERM, 1997

CENTURY OFFSHORE MANAGEMENT CORPORATION,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTIONS PRESENTED

Lessees producing natural gas under federal (and Indian) leases administered by the Secretary of the Interior have received substantial lump-sum payments from gas purchasers in settlement of previous contractual obligations to purchase gas. The questions presented are:

1. Whether the Secretary may require the payment of royalties on the portion of those settlement payments that is allocable to gas (i) originally covered by the settled contract and (ii) later actually produced and sold by the lessee.

2. Whether the court of appeals applied an inappropriate standard of review to the bankruptcy court's construction of two related contracts.

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BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-19a) is reported at 111 F.3d 443. The opinion of the district court (Pet. App. 21a-36a) is unreported. The opinion of the bankruptcy court (Pet. App. 37a-52a) is reported at 185 B.R. 734.

JURISDICTION

The judgment of the court of appeals was entered on April 14, 1997. A petition for rehearing was denied on July 23, 1997. Pet. App. 20a. The petition for a writ of certiorari was filed on October 21, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Under the Outer Continental Shelf Lands Act (OCSLA or the Act), 43 U.S.C. 1331 *et seq.*, and similar federal statutes, leases for the development of federal oil and gas resources generally call for the payment of a royalty equal to a specified percentage of the "value of the production saved, removed, or sold" by the lessee during the term of the lease. 43 U.S.C. 1337(a)(1) (offshore leases).[1] The OCSLA further directs the Secretary of the Interior to "administer the [Act's] provisions * * * relating to the leasing of the outer Continental Shelf" and to "prescribe such rules and regulations as may be necessary to carry out such provisions." 43 U.S.C. 1334(a); see also 30 U.S.C. 189; 25 U.S.C. 396, 396d. Under the Secretary's regulations, the "value of production" for royalty purposes is "under no circumstances" to be less than the "gross proceeds accruing to the lessee for lease production." 30 C.F.R. 206.152(h); see also 30 C.F.R. 206.153(h).[2] "Gross proceeds" is defined to mean "the total monies and other consideration accruing to [a] * * * gas lessee for the disposition of" gas, 30 C.F.R. 206.151, without regard to any

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[1] See also 30 U.S.C. 181, 226 (1994 & Supp. I 1995) (onshore leases under the Mineral Lands Leasing Act of 1920); 25 U.S.C. 396, 396a-396g (federally administered leases on Indian tribal and allotted lands); 25 C.F.R. 211.13 (tribal leases), 212.16 (allotted leases) (1996); 25 C.F.R. 211.41(b), 212.41(b) (1997) (amended regulations now applicable to Indian leases).

[2] The Secretary first promulgated a similar "gross proceeds" rule for onshore leases in 1936. 1 Fed. Reg. 2000 (§ 3(e)). The rule was first applied to offshore leases under the OCSLA in 1954. 19 Fed. Reg. 2659 (1954); 30 C.F.R. 250.64 (1955). The present rule applies to all federal and Indian leases.

particular characterization or "bookkeeping device" adopted by a lessee. *Kerr-McGee Oil Indus., Inc.*, 70 Interior Dec. 464, 469-470 (1963); see *Wheless Drilling Co.*, 80 Interior Dec. 599 (1973); *Hoover & Bracken Energies, Inc.* v. *United States Dep't of Interior*, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984).

It was at one time typical for companies producing natural gas under federal leases to enter into long-term contracts with pipeline operators, under which the producer agreed to dedicate certain gas reserves to a particular pipeline customer, in return for the pipeline's agreement to purchase no less than specified quantities of gas at specified prices. See generally, *e.g.*, *Independent Petroleum Ass'n of America* v. *Babbitt*, 92 F.3d 1248, 1251 (D.C. Cir. 1996) (*IPAA*). Many contracts also contained "take-or-pay" clauses, under which the purchaser agreed to pay for a minimum volume of gas during a specified period, even if it did not accept delivery of the full amount for which it paid. See *Mobil Oil Exploration & Producing Southeast, Inc.* v. *United Distribution Cos.*, 498 U.S. 211, 220-221 & n.3, 229 (1991). Most such provisions allowed the purchaser considerable time in which it could recoup, or "make up," a take-or-pay payment by applying the amount of the payment as a credit against the purchase price of gas taken in a later period in excess of the minimum required for that period under the contract ("make-up" gas). See *IPAA*, 92 F.3d at 1251; Pet. App. 4a & n.1; *Diamond Shamrock Exploration Co.* v. *Hodel*, 853 F.2d 1159, 1164 (5th Cir. 1988).

In the 1980s, market changes and a restructuring of the natural gas industry contributed to a significant drop in the price of gas. See *IPAA*, 92 F.3d at 1251.

Those changes caused pipeline companies to seek relief from the long-term, high-priced purchase commitments previously typical in the industry. Negotiations between purchasers and producers typically led to settlements under which the purchaser paid a lump sum to the producer, in return for which the producer agreed either to sell gas to the same purchaser at a lower price (a buydown), or simply to release the purchaser from any obligation to buy gas under the previous contract (a buyout). See *id.* at 1251-1252; compare Pet. App. 5a. Many settlements also included lump-sum compromises of accrued but unpaid take-or-pay liabilities. See *IPAA*, 92 F.3d at 1252.

2. Petitioner produced natural gas under federal offshore leases that it acquired between 1987 and 1990. Pet. App. 3a-4a. In 1989 and 1990, petitioner entered into a number of contracts with Enron Gas Marketing, Inc. (Enron), for the sale of gas from those leases. The contracts included both "base" contracts, which required Enron to buy minimum quantities of gas at fixed prices, and "excess" contracts, which permitted Enron to purchase additional quantities at floating prices tied to the spot market. *Id.* at 4a-5a.

By late 1991, the spot-market price for gas had declined below the price fixed in the base contracts. See Pet. App. 23a. On February 14, 1992, Enron and petitioner entered into an agreement under which Enron agreed to pay petitioner $12.25 million, subject to the "simultaneous" execution of additional agreements that (i) terminated the original base and excess contracts and (ii) substituted new purchase contracts designed to "supersede and replace" the previous contracts "in their entirety." C.A. App. 347 (letter agreement); see also Pet. App. 5a; Pet. Supp. C.A. Br. Exh. B-D (new contracts). The agreement also pro-

vided that Enron would loan petitioner up to $1.5 million to pay any royalties that the Secretary might determine to be payable, under certain leases, in respect of the $12.25 million payment. C.A. App. 348; see Pet. App. 5a.

3. Petitioner later filed a voluntary petition for bankruptcy. The United States filed a proof of claim for $1,855,004, representing petitioner's total potential liability for royalties on the $12.25 million contract settlement payment it received from Enron. Pet. App. 5a-6a, 37a-38a.[3] Petitioner objected to the government's proof of claim. *Id.* at 38a.

a. The bankruptcy court granted summary judgment for petitioner, on the ground that the Enron settlement payment was not part of petitioner's "gross proceeds" under its federal leases, and therefore gave rise to no royalty liability. Pet. App. 37a-52a. In its findings of fact, the court recited that Enron had paid petitioner $12.25 million in a "Termination of Gas Purchase Agreements." *Id.* at 40a (¶ 10). In its conclusions of law, the court characterized that payment as one "to relieve Enron of its future obligations under the" base contracts, and "not a price paid for either present or future deliveries of severed hydrocarbons to Enron." *Id.* at 43a (¶ 10). Neither the court's findings nor its conclusions mentioned the existence, or addressed the significance, of petitioner's simultaneous agreement with Enron for the continued sale of gas at new prices.

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[3] Because the Secretary's royalty claim was first made in petitioner's bankruptcy proceeding, there was no administrative proceeding concerning royalties on the settlement proceeds, and the Secretary has never issued a formal administrative determination or order with respect to this case.

On the basis of its findings and conclusions concerning petitioner's contractual arrangement with Enron, the court held that the Fifth Circuit's decision in *Diamond Shamrock Exploration Co.* v. *Hodel*, which held that the Secretary could not demand a royalty on a take-or-pay payment unless and until make-up gas was actually produced and sold, compelled the conclusion that Enron's payment was not part of the "value of production" subject to royalty under petitioner's federal leases. Pet. App. 40a-43a. The court rejected the government's argument that the payment was, in effect, a partial prepayment for the later sale of gas under the superseding purchase contracts. *Id.* at 44a. It believed, furthermore, that the Secretary had previously acquiesced in the construction of *Diamond Shamrock* adopted by the court; and that, having done so, he was not free to assess royalties on the payment at issue in this case. *Id.* at 43a-44a. The court expressly refused to defer to the Secretary's contrary position, on the grounds that that position was arbitrary and capricious, had been adopted without compliance with the notice-and-comment provisions of the Administrative Procedure Act (APA), 5 U.S.C. 553, and was impermissibly retroactive. *Id.* at 45a-52a.

b. The district court affirmed. Pet. App. 21a-36a. That court, too, refused to defer to the Secretary's construction of the applicable statute and regulations. *Id.* at 27a-33a. It held that the decision in *Diamond Shamrock* represented "a definitive interpretation of the statute, the implementing regulations, and the relevant contract provisions," and that there was therefore "no need or obligation for [the] Court to defer" to the Secretary's position. *Id.* at 30a. The

court also rejected the Secretary's position as "impermissible" on the ground that "interpreting 'gross proceeds' to include payments made not for natural gas but rather to terminate a contractual obligation * * * exceeded [the Secretary's] statutory, regulatory, and contractual authority." *Id.* at 30a-31a. Alternatively, the court concluded that the Secretary's interpretation of the "gross proceeds" regulation was "arbitrary and capricious" (*id.* at 31a-33a) and "unlawfully retroactive" (*id.* at 33a-34a). The court reversed, however, the bankruptcy court's holding that the Secretary's interpretation had not been properly adopted under the APA. *Id.* at 34a-35a.

c. The court of appeals reversed. Pet. App. 1a-19a. Observing first that interpretation of the contractual relationship between petitioner and Enron was "a matter of law subject to *de novo* review" (*id.* at 8a n.3), the court held that the termination of the 1989 and 1990 purchase contracts and their simultaneous replacement by the 1992 purchase contracts constituted "one transaction for the purposes of the instant dispute" (*id.* at 8a). It then concluded that the lump-sum payment made by Enron as part of that transaction "contemplated and was the cause of new gas sales to be delivered in the future" as part of the "continuing relationship" intended by the parties, and therefore "behaved as an advance payment under a substituted requirements contract." *Id.* at 9a. Thus, although, as with any advance-payment contract, "the government would not be entitled to its royalties until production" of the purchased gas, the lump-sum payment "was for 'production sold' under the statute, and the royalty was payable when the gas was produced." *Ibid.*

The court rejected petitioner's argument that the decision in *Diamond Shamrock* required a contrary result. Pet. App. 9a-11a. The court noted that *Diamond Shamrock* addressed only "the royalty consequences of take-or-pay payments" when they were first made. *Id.* at 9a. Thus, the court below explained, as a practical matter *Diamond Shamrock* affected primarily the timing of royalties on such payments, permitting the government to collect them only "if and when make-up gas is actually produced." *Id.* at 10a. Reading *Diamond Shamrock* to require only "some nexus with production" before a payment could become subject to royalties (*ibid.*), the court held (*id.* at 11a) that the necessary nexus "exist[ed] under the facts of th[is] case" because "virtually all" the gas originally covered by the 1989 and 1990 contracts was ultimately purchased by Enron under the "simultaneous replacement contracts" signed by the parties in 1992. Once that gas was produced and sold to Enron under the replacement contracts, "royalty payments [became] due, not merely on the price Enron ultimately paid, but on that price plus the amount of the lump sum payment allocable to the gas ultimately taken." *Ibid.*

The court similarly rejected petitioner's contention that the Secretary's response to *Diamond Shamrock* foreclosed his position in this case. Pet. App. 11a-12a. The court noted that, rather than further contesting the holding in *Diamond Shamrock*, the Secretary had amended his royalty regulations to accept and adopt a "very narrow interpretation" of that decision. *Id.* at 11a. The court explained, however, that, although the regulatory amendments retreated from the position that royalties on take-or-pay payments were due as soon as the payments were

made, "[t]he government never conceded * * * that it would not seek royalties once a sufficient link to production [was] established." *Id.* at 11a-12a. Again construing petitioner's simultaneous agreements with Enron as "one transaction," the court held that they provided just such a "link" between Enron's lump-sum payment and petitioner's later production under the superseding purchase contracts. *Id.* at 12a.

The court sought to distinguish the D.C. Circuit's decision in *Independent Petroleum Association of America* v. *Babbitt*, which had held that the Secretary was not entitled to any royalty on a lump-sum settlement payment made by a gas purchaser to terminate its obligations under a contract with a federal lessee (and to compromise take-or-pay liabilities previously accrued under that contract). Pet. App. 14a-15a. Noting that the gas covered by the contract settled in *IPAA* was subsequently sold, not to the settling purchaser itself, but to a third-party, the court characterized that case as involving "a situation in which a nexus with production did not exist." *Id.* at 15a. In the court's view, it was "not at all clear how the [*IPAA*] court would have dealt with the instant case." *Ibid.*; see also *id.* at 6a n.2.

Finally, the court of appeals "d[id] not find compelling" the arguments advanced by petitioner and the lower courts that acceptance of the Secretary's position would lead to arbitrary or "absurd" results (Pet. App. 13a-14a), and it rejected (*id.* at 16a-19a) petitioner's arguments based on the asserted "retroactivity" of the Secretary's construction and on the notice-and-comment requirements of the APA. The court therefore reversed the district court's decision on the royalty question, and remanded the matter for

a determination of the amount of the royalty due. *Id.* at 19a.

DISCUSSION

The court of appeals in this case correctly held that a federal lessee owes royalties on a lump-sum payment made by a gas purchaser to settle or terminate its contractual purchase obligations, if and to the extent the lessee later produces and sells gas previously covered by the settled contract. That decision conflicts, however, with the decision of another court of appeals, and we are informed that the federal royalties at stake in connection with such transactions amount to several hundred million dollars. We therefore agree with petitioner that the first question presented by the petition merits this Court's review.[4]

1. As we have explained (see pages 2-3, *supra*), federal leasing statutes, including the Outer Continental Shelf Lands Act (OCSLA or the Act), generally require the payment of royalties calculated as a

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[4] Petitioner also seeks review of whether the court of appeals improperly disturbed the bankruptcy court's "findings of fact." Pet. i, 15-17. That argument apparently relates to the court's conclusion (Pet. App. 8a-9a & n.3) that petitioner's 1992 agreements with Enron should be treated as "one transaction" for purposes of this case. That conclusion was based on the court's evaluation and construction of the parties' overall contractual relationship—a legal issue properly subject to de novo review. *Id.* at 8a n.3; see also *Klein* v. *Arkoma Prod. Co.*, 73 F.3d 779, 785 (8th Cir.), cert. denied, 117 S. Ct. 65 (1996). Indeed, the bankruptcy court, on whose "findings" petitioner seeks to rely, took the same view: The only "factual findings" to which petitioner alludes (Pet. 16) are set out in that court's opinion as "conclusions of law" (Pet. App. 40a, 43a). This case thus presents no standard-of-review question that might warrant review by this Court.

percentage of the "value of the production saved, removed, or sold" by a federal lessee during the term of a lease. 43 U.S.C. 1337(a)(1). Exercising his statutory authority to administer the OCSLA and to "prescribe such rules and regulations as may be necessary to carry out [its] provisions," 43 U.S.C. 1334(a), the Secretary of the Interior has specified that the "value of production" for royalty purposes is "under no circumstances" to be less than the "gross proceeds accruing to the lessee for lease production." 30 C.F.R. 206.152(h); see also 30 C.F.R. 206.153(h).

The Secretary further defines "gross proceeds" to mean "the total monies and other consideration accruing to [a] * * * gas lessee for the disposition of" gas. 30 C.F.R. 206.151. In this and other cases, the Secretary has consistently interpreted that definition of "gross proceeds" to include lump-sum payments made to a lessee in settlement of contractual commitments to purchase gas, if and when the lessee thereafter produces and sells the gas that would otherwise have been subject to the settled obligation. See *Shell Offshore, Inc.*, MMS-91-0087-OCS (Sept. 2, 1994); *Samedan Oil Corp.*, MMS-94-0003-IND (Sept. 16, 1994). Finally, the Secretary has long insisted that all royalty valuation questions, including the amount of a lessee's gross proceeds, be resolved on the basis of economic substance, rather than as a matter of mere transactional form.[5]

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[5] See, *e.g.*, note 6, *infra*; *Enron Oil & Gas Co.* v. *Lujan*, 978 F.2d 212, 215-216 (5th Cir. 1992) (reimbursement for severance taxes included in "gross proceeds"), cert. denied, 510 U.S. 813 (1993); *Mesa Operating Ltd. Partnership* v. *United States Dep't of Interior*, 931 F.2d 318, 323-325 (5th Cir. 1991) (same as to reimbursement of certain gas treatment costs), cert. denied, 502 U.S. 1058 (1992); *Hoover & Bracken Energies, Inc.* v.

a. The Secretary's interpretation of his "gross proceeds" rule in this context makes simple economic sense. As we have explained (see pages 3-4, *supra*), the contract settlements at issue in this and similar cases arose because federal lessees like petitioner had entered into long-term, fixed-price contracts for the sale of the gas they produced from their leases. Under those contracts, the lessees expected to produce and sell gas at a reasonably predictable pace and for a predictable price—on all of which they would, of course, owe a royalty to the government as lessor.

After a substantial drop in the market price of natural gas, the same lessees found themselves holding valuable contract rights to receive significantly higher prices—subject, however, to a variety of legal and business risks, such as that the purchasers would contest their continued contractual liability, would demand concessions as a condition of doing other business, or would be driven into bankruptcy. The net result was usually, as in this case, a negotiated settlement between the lessee and its purchaser, under which the purchaser paid a lump sum to the lessee in return for either a change in the price terms of the contract or a complete release from the contract's purchase obligations. See, *e.g.*, *Independent Petroleum Ass'n of America* v. *Babbitt*, 92 F.3d 1248, 1251-1252 (D.C. Cir. 1996) (*IPAA*).

United States Dep't of Interior, 723 F.2d 1488, 1491-1492 (10th Cir. 1983) (tax reimbursement), cert. denied, 469 U.S. 821 (1984); *Wheless Drilling Co.*, 80 Interior Dec. 599 (1973) (same); *Kerr-McGee Oil Indus. Inc.*, 70 Interior Dec. 464, 469-470 (1963) (same); see also *Pennzoil Exploration & Prod. Co.* v. *Lujan*, 751 F. Supp. 602, 605-606 (E.D. La. 1990), aff'd, 928 F.2d 1139 (TECA 1991) (sales under special statutory incentive program).

In either case, of course, the lessee in fact continued to produce gas under its federal leases; and it continued to sell that gas, at a new price, either to the original purchaser or to third parties. Thus, as an economic matter, the lessee would generally produce and sell all of the gas that had been committed under a settled contract, for an effective price equal to (i) the per-unit price received for gas produced after the settlement, plus (ii) the amount previously received in settlement of the original purchaser's previous contractual obligation to purchase the same gas (generally at a higher per-unit price). Under those circumstances, the Secretary reasonably concluded that a federal lessee should calculate the royalties it owes to the public not only on the amount received for usually lower-price purchases after the settlement, but on the whole amount, including the settlement payment, that the lessee actually received from purchasers in respect of gas produced and sold under its lease.

b. The fact that high-price purchase obligations were typically, as here, settled with lump-sum payments presented a further issue concerning the *timing* of a lessee's royalty obligations. A similar question had previously arisen in the context of take-or-pay payments, which are made as a lump sum in one period and then often may be applied in increments to "make-up" gas taken by the purchaser in later periods. See page 3, *supra*. Originally, the Secretary took the position that take-or-pay payments were always part of the consideration for any gas purchased under a particular contract, and that they were therefore subject to royalties at the time they were made. See, *e.g.*, 30 C.F.R. 206.151 (1988) (including take-or-pay payments within the definition

of "gross proceeds"); 53 Fed. Reg. 1184, 1194-1195, 1230, 1241-1242 (1988).

The Fifth Circuit rejected that position in *Diamond Shamrock Exploration Co.* v. *Hodel*, 853 F.2d 1159 (1988), holding instead that the relevant statutory, regulatory and contractual provisions called for royalties only on "the value of *production* * * * from the leased property," and that royalties therefore did not become due on any payment "unless and until actual production, the severance of minerals from the formation, occurs." *Id.* at 1165. Thus, in the court's view, a take-or-pay payment *did* give rise to a royalty obligation—but only when, and to the extent that, the quantity of untaken gas to which it related was later produced and delivered as "make-up" gas. *Id.* at 1167-1168.

The Secretary chose not to continue litigating the question at issue in *Diamond Shamrock*, which was (as the court below recognized, Pet. App. 10a) largely one of timing. Instead, the Secretary's "gross proceeds" regulation was amended to delete the requirement that take-or-pay payments be included in a lessee's "gross proceeds" when received. 53 Fed. Reg. 45,082 (1988). As the court below noted (Pet. App. 12a), however, the Secretary continued to require the payment of royalties on such payments if and when the untaken gas was subsequently produced and sold. See 53 Fed. Reg. 45,083 (1988).[6]

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[6] In responding to *Diamond Shamrock*, the Secretary emphasized that the "changes to the regulations * * * [were] consistent with, and [were] the minimum necessitated by, the Fifth Circuit's * * * decision." 53 Fed. Reg. 45,084 (1988). He further cautioned that production-value determinations would continue to be "premised on the concept that royalty value cannot be less than the gross proceeds accruing to the

The issue of the treatment of lump-sum settlement payments arose against this backdrop. The Secretary accordingly adopted a position consistent both with *Diamond Shamrock* and with his subsequent treatment of take-or-pay payments. In two final decisions issued by his delegates, the Secretary concluded that lump-sum settlement payments should be incrementally attributed to gas originally required to be taken under the settled contract, the purchase price of which had been modified as a result of the settlement payment. *Shell Offshore, Inc.*, MMS-91-0087-OCS (Sept. 2, 1994); *Samedan Oil Corp.*, MMS-94-0003-IND (Sept. 16, 1994). If that gas was produced and sold after the settlement (and during the term of the original contract), an allocable portion of the settlement payment would be subject to royalty at the time of production. If some or all of the gas subject to the original contract was never produced, then no royalty would be owed on the corresponding portion of the settlement.

That sensible position is the one advanced by the Secretary in this case. As the court of appeals held (Pet. App. 8a-16a), requiring the payment of royalties on the entire amount received by petitioner for gas that it produced and sold under a federal lease simply applies the governing principles supplied by the Act, the Secretary's regulations, and petitioner's lease to the economic realities of petitioner's situation. In addition, even if the matter were debatable, the

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lessee," and that his delegates would "carefully review all situations to ensure that lessees do not improperly attempt to use contractual devices to avoid royalties by denominating as take-or-pay or advance payments other consideration which is part of the gross proceeds for production." *Ibid.*

Secretary's regulatory implementation of the federal leasing statutes that Congress has charged him to administer is entitled to deference, see *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-845 (1984); and his construction of his own regulations, including the value-of-production and "gross proceeds" rules in 30 C.F.R. 206.151 and 206.152(h), is entitled to "controlling weight." *Security Servs., Inc.* v. *K Mart Corp.*, 511 U.S. 431, 436 n.2 (1994); see also, *e.g.*, *Auer* v. *Robbins*, 117 S. Ct. 905, 911 (1997); *Stinson* v. *United States*, 508 U.S. 36, 45 (1993); *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965); *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945). The court of appeals therefore correctly rendered judgment in favor of the Secretary in this case.

2. We agree with petitioner (Pet. 12-14), however, that the decision in this case, upholding the Secretary's right to receive royalties from petitioner with regard to a contract settlement payment, conflicts in principle with the D.C. Circuit's decision in *Independent Petroleum Association of America* v. *Babbitt*, *supra*. The straightforward legal issue involved here is an important one both to the government and to federal lessees, and review at this time would enable all affected parties, and the courts, to avoid a considerable amount of protracted and ultimately unproductive litigation. We therefore concur in petitioner's request that the Court grant review and resolve the issue in this case.

a. *IPAA* reversed the Secretary's decision in *Samedan Oil*, one of the two administrative decisions that first applied the Secretary's interpretation of the "gross proceeds" rule in the settlement-payment con-

text. See page 15, *supra*.[7] In *Samedan*, the Secretary assessed royalties on a payment received by a lessee in exchange for settlement of accrued but unpaid take-or-pay liabilities and a release from any future purchase obligations under a contract, to the extent that the lessee later produced and sold (to a third party) the gas originally committed under the settled contract.

The D.C. Circuit rejected the Secretary's position. 92 F.3d at 1258-1260. Concluding that settlement payments were "functionally indistinguishable" from take-or-pay payments for royalty purposes, the court held that it was "arbitrary and capricious" for the Secretary to attempt to collect royalties on such payments, when in the take-or-pay context he had "read *Diamond Shamrock* as requiring a link between royalty-bearing payments and severed gas and * * * regulated accordingly." *Id.* at 1260. In evaluating the presence or absence of such a "link," the D.C. Circuit, unlike the Secretary, focused exclusively on whether a payment received by the lessee was subject to some explicit contractual recoupment provision:

> The relevant question * * * is whether or not the funds making up the payment actually pay for any gas severed from the ground. When take-or-pay payments (or settlement payments) are

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[7] Samedan's case was consolidated with a challenge by an industry trade association to the views expressed in a letter to royalty payors dated May 3, 1993—before the agency's decisions in *Samedan* and *Shell Offshore*—from an Associate Director of the Department of the Interior's Minerals Management Service. See *IPAA*, 92 F.3d at 1253-1255. The court ultimately held that the May 3 letter was not subject to review as an agency "rule," because it "did not bind the agency in any way." *Id.* at 1256-1257.

> recouped, those funds do pay for severed gas. But when the payments (of either variety) are non-recoupable, the funds are never linked to any severed gas. * * * Neither take-or-pay payments nor take-or-pay settlement payments are royalty bearing unless and until they are credited toward the purchase of make-up gas.

Id. at 1260. Thus, the court held, in effect, that the only cognizable "link" was an express contractual provision like the one involved in *Diamond Shamrock* —that is, the link established when all or part of a take-or-pay payment is explicitly credited against the price of "make-up" gas that is later produced and sold by the lessee to the same purchaser under the same contract.

b. The reasoning of the *IPAA* decision conflicts with that of the decision below in two important respects, both of which go to the heart of why this case was correctly decided, and *IPAA* was not.

1. First, *IPAA* improperly adopted a very narrow and formalistic view of the "link" between a particular payment and the production of gas that is necessary for the government, as owner of the gas in question and grantor of the development rights being exploited by the lessee, to claim a royalty. By focusing on its take-or-pay analogy and speaking in terms of payments "credited toward the purchase of make-up gas" (92 F.3d at 1260), the D.C. Circuit suggested that it would look for the existence of an explicit provision tying past payments to future production through some formal contractual accounting mechanism.

That approach contrasts sharply with the reasoning of the Sixth Circuit in this case. See Pet. App.

10a-12a. The decision below recognized the need, under *Diamond Shamrock* and the Secretary's regulations, for "some nexus with production" to permit the assessment of royalties on a particular payment. *Id.* at 10a. The court rejected, however, the formalistic analysis advanced by petitioner, under which no such "nexus" could exist because the settlement payment was made to extinguish one set of contracts, while any gas produced and sold after the settlement was covered by a new set of documents. See *id.* at 7a-8a & n.4, 11a-12a. The court looked instead to the economic realities of the situation, treated the parties' various formal contractual arrangements as functionally "one transaction" (*id.* at 8a), and held that "the necessary nexus to production exists under the facts of th[is] case" (*id.* at 11a). See also *id.* at 12a (liability for royalties does not turn on whether the lessee used "one piece of paper" or "two pieces of paper" to document its agreements).

The functional analysis employed by the court below, focusing on the economic substance of the transactions at issue rather than on their contractual form, is consistent with the Secretary's longstanding approach to royalty issues. See page 11 & note 5, *supra*. It is also consistent with the holdings of courts that have considered leases among private parties, interpreting them in accordance with state law and the basic purposes of mineral development leases. See *Klein* v. *Jones*, 980 F.2d 521, 527-532 (8th Cir. 1992) (discussing principles and other cases), cert. denied, 117 S. Ct. 65 (1996); *Frey* v. *Amoco Prod. Co.*, 943 F.2d 578, 580-586 (5th Cir. 1991) ("It would be contrary to the nature of the lease as a cooperative venture to allow a benefit *by any name* that is attributable to the gas under the leased premises to inure

exclusively to the lessee.") (*id.* at 584) (emphasis added), withdrawn in part, 951 F.2d 67, reinstated, 976 F.2d 242 (1992); *Frey* v. *Amoco Prod. Co.*, 603 So. 2d 166 (La. 1992); see also D. Harrell, *Developments in Nonregulatory Oil and Gas Law*, 30 Inst. on Oil & Gas L. & Tax'n 311, 336-337 (1979) ("[A]ny determination of the market value of gas which * * * permits either the lessor or the lessee to receive a part of the gross revenues from the property greater than the fractional division contemplated by the lease, should be considered inherently contrary to the basic nature of the lease."). The same sort of analysis led the Secretary's delegate to reach the decision that she did in *Samedan*. See, *e.g.*, *IPAA*, 92 F.3d at 1254 (quoting agency decision). That functional approach cannot, however, be reconciled with the highly formal analysis that led the D.C. Circuit to overturn the *Samedan* decision in *IPAA*.

2. The second fundamental conflict between *IPAA* and the decision below involves the two courts' different willingness to respect the Secretary's decisions concerning how to administer the OCSLA and how to interpret and apply his own regulations. The court of appeals in this case correctly held that the Secretary's present position is entirely consistent with *Diamond Shamrock* (see Pet. App. 9a-12a). Indeed, the court explicitly pointed out that the Secretary, in amending his regulations to accommodate that decision, had "never conceded" that he would not seek royalties in a case like this one, "once a sufficient link to production [was] established." *Id.* at 12a; see note 6, *supra*.

The *IPAA* court, on the other hand, premised its entire decision on a supposed inconsistency between the Secretary's position in *Samedan* and his "*adop-*

tion and application of *Diamond Shamrock*." 92 F.3d at 1259; see also, *e.g.*, *id.* at 1258 ("[I]f [the Secretary's] interpretation of the gross proceeds rule is unreasonable, it is unreasonable because the application of that interpretation in the case of * * * settlement payments constitutes an unexplained departure from the agency's adoption of *Diamond Shamrock*."). That analysis depends, of course, on the court's attribution to the Secretary of an intention to acquiesce, in his post-*Diamond Shamrock* regulatory amendments, in the broad interpretation of the Fifth Circuit's decision that the *IPAA* panel majority itself later adopted. See, *e.g.*, *id.* at 1260 & n.3 (after "adopting" a court decision, an agency may not treat two cases differently "where the rationale of the court decision applies to both"). The court's imputation of that intention to the Secretary was improper, however, because it is the Secretary's prerogative to tailor or limit the regulations that he adopts in the first instance—and to interpret them later, in accordance with his own permissible constructions of the statutes that he administers and, in this case, of what he regards as "the minimum [regulatory change] necessitated by" a particular court decision. 53 Fed. Reg. 45,084 (1988); see note 6, *supra*. The court of appeals in this case understood and observed that principle, see Pet. App. 11a-12a, and its rejection of petitioner's argument "that the government's response to *Diamond Shamrock* foreclosed its approach to the instant case" (*id.* at 11a) conflicts directly with the D.C. Circuit's acceptance of the same argument in *IPAA*.

c. The court below sought to distinguish *IPAA* on the ground that this case involved a continuing contractual relationship with one purchaser, whereas

IPAA involved substituted sales of gas to a third party. Pet. App. 6a n.2, 14a-15a. We note, however, that the Secretary's interpretation of his regulations—argued both below and in *IPAA*—draws no such distinction. Although the court below explicitly reserved judgment on the point (see *id.* at 6a n.2), its adoption of a functional analysis consistent with the Secretary's approach, and its evident willingness to accept the Secretary's construction of his own regulations, strongly suggest that, so long as the appropriate "nexus" could be shown, it would agree with the Secretary's assessment of royalties even in a case like *Samedan* that involved a third-party purchaser.[8]

Whether the D.C. Circuit might, if presented with a case like this one, limit its holding in *IPAA* to third-party situations is a more difficult question. The district court in which the *IPAA* case is now pending on remand has attempted (over the government's objection) to distinguish that case from the decision below, on the ground that *IPAA* dealt only with "true nonrecoupable take-or-pay payments or settlement payments," while the Sixth Circuit in this case merely "saw through" the parties' attempt to "avoid make-up contracts, which would be subject to royalties." *IPAA* v. *Babbitt*, 971 F. Supp. 19, 32-33 (D.D.C. 1997) (*IPAA II*). Should the matter return to the D.C. Circuit, the government is prepared to argue

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[8] The substituted "third-party" contract at issue in *Samedan* and *IPAA* was signed on the same day as the settlement agreement that gave rise to the lump-sum payment. 92 F.3d at 1254. That circumstance implies that the two agreements were, from Samedan's point of view, part of one overall business transaction. The particular facts at issue in *IPAA* were therefore very close to those in this case. Compare Pet. App. 5a, 8a-9a.

that some such limiting recharacterization of the original *IPAA* decision, to accommodate at least a degree of functional rather than purely formal analysis, would be preferable to any extension of that decision to its logical extreme. Given, however, the *IPAA* court's focus on whether settlement funds "actually pay for * * * gas" by being "credited toward the purchase of make-up gas" (92 F.3d at 1260), and its refusal to accept the Secretary's explanation of his own regulatory intentions, discussed above, there is considerable reason to question the likelihood that the D.C. Circuit will retreat from the sterile formalism of its first opinion. In the meantime, both the underlying issue in these cases and continuing arguments over the exact legal and geographical scope of the D.C. Circuit's decision in *IPAA* will continue to generate a good deal of essentially unproductive litigation. See *IPAA II*, *supra*.[9] There is therefore little reason for the Court to postpone review of this case in order to await further developments in the lower courts.[10]

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[9] In *IPAA II*, the trade association plaintiff has urged the district court to impose a nationwide injunction barring the Secretary from endeavoring to recover royalties on contract settlement payments, including further consideration of pending administrative appeals. See 971 F. Supp. at 23-24. The plaintiff's motion to alter or amend the court's initial judgment rejecting that request is still pending. In the meantime, the district court has already enjoined the Secretary from pursuing additional administrative proceedings involving Samedan Oil itself—including proceedings involving payments that were not at issue in the original Samedan litigation. *Id.* at 30-35.

[10] A federal lessee is generally entitled to seek judicial review of a final royalty assessment by filing suit against the Secretary in the District of Columbia. See 28 U.S.C. 1391(e). Because lessees may be expected to seek maximum advantage

3. Proper resolution of the question presented in this case will directly affect the Secretary's ability to recover very substantial royalties due under leases for the development of public and Indian natural gas resources. One study of contract settlements estimated that from 1982 through 1990, federal and Indian gas lessees received a total of approximately $4.6 billion in contract settlement payments (out of a total of approximately $10 billion in such payments received by all lessees), with an estimated total potential royalty yield of $754 million. U.S. Dep't of the Interior, Office of the Inspector General, *Audit Report No. 92-I-657: Gas Contract Settlements, Minerals Management Service* 4 (March 1992). We are informed that more recent estimates, based on data reported to the Secretary by lessees, suggest total settlement payments through 1993 on the order of $18 billion, a substantial proportion of which would have related at least in part to gas covered by federal or Indian leases. Those leases generally provide for royalties of between 12.5% and 16% of the lessee's "gross proceeds." The Secretary estimates that, to date, he has collected approximately $200 million in royalties on settlement payments, and that perhaps another $70 million in royalties is at issue in the more than 150 appeals that are presently pending

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from the decision in *IPAA*, future litigation is likely to be concentrated in the D.C. Circuit. While that fact may mute the potential for disparate results that normally arises from a conflict in the circuits, it also magnifies the very substantial damage (discussed below) inflicted by the error in *IPAA*; deprives the government of the opportunity to litigate the issue in other circuits; and correspondingly lessens any advantage that might otherwise accrue from allowing further consideration of the matter by various courts of appeals.

before the Director of the Department of the Interior's Minerals Management Service.[11] More than 500 additional settlements have not yet been audited.[12]

Under the functional approach adopted by the court of appeals in this case, the Secretary would be able to administer the relevant statutes and his own regulations to ensure that those sizable settlement payents do not become mere windfalls to lessees. So long as a functional "link" or "nexus" could be shown between a settlement payment and the lessee's subsequent production and sale of gas under its leases, the Secretary could properly require that that payment be shared with the owners of the gas produced and sold, in accordance with the terms of the lease. By contrast, the formalistic analysis embraced by the D.C. Circuit in *IPAA* would evidently allow lessees to avoid paying royalties on amounts (i) received from customers, (ii) in settlement of gas purchase obliga-

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[11] Final adminstrative decisions in 134 of those appeals must be issued by May 13, 1999, under amendments made by the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996, Pub. L. No. 104-185, § 4(a), 110 Stat. 1709 (enacting a new provision to be codified at 30 U.S.C. 1724(h)). By enacting new time limits for administrative decisions, Congress has indicated a specific interest in the timely resolution of royalty disputes. Definitive resolution of the widely relevant issue presented in this case would contribute materially toward the realization of that goal.

[12] We are informed that some federal coal lessees have also begun to contend, on the basis of *IPAA*, that the Secretary may not recover royalties on settlement payments made with respect to coal purchase contracts, because those contracts do not contain express "recoupment" provisions. The statutory and regulatory provisions applicable to royalties on federal coal leases are similar to those at issue in this case. See 30 U.S.C. 207(a); 30 C.F.R. 206.251, 206.257.

tions, (iii) fairly allocable to gas originally committed under the settled contract, and (iv) later actually produced and sold by the lessee, so long as the relevant contracts do not expressly refer to those amounts as part of the overall price received for later-sold gas. That exaltation of form over substance permits obvious and wholly inappropriate opportunities for the manipulation of royalty amounts by lessees and gas purchasers—who share, in that regard, a common economic interest quite adverse to that of the public and Indian lessors whose interests it is the Secretary's duty to protect. See, *e.g.*, *Klein*, 980 F.2d at 531; see also Pet. App. 15a-16a ("It is important to remember that Century and other producers do not own the land that is the subject of these leases."); 43 U.S.C. 1332(3) ("the outer Continental Shelf is a vital national resource reserve *held by the Federal Government for the public*" (emphasis added)).[13]

The decision in this case makes clear that there is, at a minimum, serious reason to doubt the correct-

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[13] Congress has previously manifested its concern with effective enforcement of royalty obligations on federal and Indian leases. Concerned that what was essentially an "honor system" of royalty collection had proved ineffective (see H.R. Rep. No. 859, 97th Cong., 2d Sess. 15 (1982)), Congress enacted the Federal Oil and Gas Royalty Management Act of 1982, Pub. L. No. 97-451, 96 Stat. 2447 (1983) (codified at 30 U.S.C. 1701 *et seq.*). That Act states Congress's finding that the then-existing system for accounting for royalties was "archaic and inadequate," and its intention that the Secretary "develop[] * * * enforcement practices that ensure the prompt and proper collection * * * of oil and gas revenues owed to the United States and Indian lessors" and "aggressively carry out his trust responsibility in the administration of Indian oil and gas." 30 U.S.C. 1701.

ness of the decision in *IPAA*. We believe that the *IPAA* court erred, both in interpreting the applicable law and regulations and in failing to defer to the Secretary's contrary determinations. Those errors, if not corrected by this Court, will largely control future litigation on this issue (see note 10, *supra*), and they will cause very significant damage to the public fisc and to financial interests that are often of critical importance to Indian lessors, to whom the United States owes an important trust responsibility. For all these reasons, we agree with petitioner that the first question presented warrants review and resolution by this Court.

CONCLUSION

With respect to the first question presented, the petition for a writ of certiorari should be granted. In all other respects, the petition should be denied.

Respectfully submitted.

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